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Satterlee, Hugh

Revision of federal taxation

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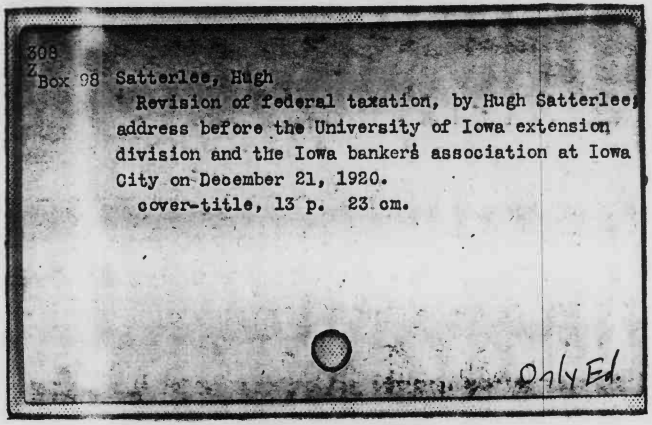
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Revision of Federal Taxation

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BY
HUGH SATTERLEE

Address before the University of Iowa
Extension Division and the Iowa Bankers' Association
at Iowa City on December 21, 1920

Cto June 30, 1923.
Act

REVISION OF FEDERAL TAXATION

The topic which has been assigned to me is "Should the present basis of federal taxation be changed and why?" If I confined myself to this subject I should not need to speak very long. Supposing, however, that if we agree that the present basis of federal taxation should be changed, you may be interested in suggestions as to how it should be changed, I shall proceed, after disposing of my assigned topic in rather a summary fashion, to discuss various proposals for a revision of the existing revenue system.

Necessity for Change of Present Basis

Unqualifiedly, the present basis of federal taxation should be changed. There are two sufficient reasons for this dogmatic statement.

The first reason is that a change is *desirable*, because our present system, if it can be called that, is in part a temporary structure thrown together purely for war purposes, like many other war facilities which served their purpose and have been discarded; is in part an outgrown rambling edifice coming down from earlier, and perhaps happier, days when all the Government asked of the Internal Revenue Bureau was the collection of a hundred million dollars annually; and is in part a dumping ground for reform measures which could not find any other department to administer them.

The second reason is that a change is *necessary*, because the Internal Revenue Bureau cannot administer the existing taxes; the country cannot prosper under them; and the Government cannot derive enough revenue from them. This may sound like putting it rather strong, but it is the stark truth.

The Internal Revenue Bureau, which in all its history never

in any year until 1915 had collected more than $400,000,000, in 1918 collected more than $3,000,000,000, in 1919 about $4,000,000,000 and in 1920 more than $5,000,000,000. Consider for a moment what an expansion similar to this would entail in any business organization! In addition to being beset with barnacles of the past and burdened with the responsibility for the enforcement of reform measures, the Bureau has had to administer in the excess profits tax the most complicated tax ever devised by the brain of man.

The Internal Revenue Bureau has put forth superhuman efforts and has accomplished wonders, but it cannot perform the impossible. It has not yet completed auditing the returns for 1917, the first year of the excess profits tax, and it has barely touched the returns for 1918 and 1919. The returns for 1920 will soon be filed, and the Bureau is getting further and further behind every day. Even the advocates of the tax as a war measure now admit that, especially as a tax during peace times, the excess profits tax is incapable of administration.

So far as the effect on the country is concerned, the results of the excess profits tax on corporations and of the higher rates of surtax on individual incomes are everywhere evident. Although I doubt the ethics of taking away most of a man's income in taxation, even though he be rich, we need only look at the matter from the standpoint of the selfish interests of the mass of the people. The country cannot prosper so long as enterprise is stifled, and enterprise has been and is being stifled. It is an axiom that the power to tax includes the power to destroy, and the latter power has come perilously near to being exercised.

Corporations and individuals alike are naturally reluctant to enter upon new ventures, the profits of which go chiefly to a special partner, the Government, and the losses of which they bear alone. Wasteful expenditures are often made because the Government pays the larger part. Because of the existence of tax-exempt securities, consisting chiefly of bonds of municipalities

and other local subdivisions of the States, which may be issued without limit, the rich are encouraged and almost compelled to withdraw their funds from active enterprises and to invest them in securities the interest on which is free from tax. By taking a little thought a millionaire may today pay less tax than the man who earns $5,000 a year by the sweat of his brow. So I say the country cannot prosper, it can scarcely live, under such conditions.

The conditions I have sketched lead inevitably to the conclusion that a continuance of the present system of taxation will not yield sufficient revenue for the needs of the Government. Not only is the excess profits tax so complicated and so open to different constructions that taxpayers can hardly be blamed for giving themselves the benefit of the doubt and making their initial tax payments often less than they should be, but because of the delay in auditing their returns, a delay forever growing longer, much of the tax that is actually due for any year cannot be discovered and collected until years after. Because of the stifling of enterprise, and of the investment of accumulations of capital in tax-exempt securities, the corporations will have less and less excess profits and rich individuals will have less and less taxable income. The present fall in prices, and the consequent diminution in profits, is a warning of the folly of basing a system of federal taxation almost wholly on the assumed existence in every year of large taxable profits. The Government must go on in lean years as well as in fat.

Even those of us who might like to see the rich pay all the taxes must admit that the present system does not begin to achieve their ends. Let no one delude himself with the notion that because the present tax laws appear to tax large incomes the rich are in the final analysis paying the taxes. When they do not hide their five talents they make the other fellow pay for the Government's participation in the profits of every commercial venture.

If, then, the present basis of federal taxation should and

must be changed, how best shall we get away from the evils of the present system and provide a permanent system of taxation that shall be capable of administration, not unduly burdensome, and sufficiently productive? This is a large order, but it must be delivered. The problem is summed up in the three words "repeal, revision and replacement." That is to say, we must weed out the taxes that are useless or worse than useless, we must revise the remaining taxes, and we must add new taxes to make up any deficiency in revenue resulting from the abolition of some of the old.

Survey of Federal Taxes.

As a practical matter there are four principal classes of internal taxes which have been and can be imposed by the United States Government. These are:

I. Income Taxes;

II. Inheritance Taxes;

III. Occupation Taxes; and

IV. Sales Taxes.

Income taxes comprise, of course, the income tax and the profits tax, and also the child labor tax. The existing form of inheritance taxes is the estate tax. The occupation taxes comprise license taxes on about thirty different occupations and businesses, including the capital stock tax on corporations. The sales taxes now in force include about seventy-five taxes on commodities, sales of real estate, sales of the use of property, sales of choses in action, and sales of services.

The foregoing broad classification regards the basis of the tax in each case, not its purpose. A tax within any of the four classes may be imposed for the purpose of producing revenue, or for the widely different purpose of regulating business. With

reference to their purpose, therefore, taxes are either revenue taxes or regulatory taxes.

Repeal of Certain Taxes.

Whatever may be said for or against the different revenue taxes, the initial step in a revision of federal taxation should be the transfer to some other bureau of the regulatory taxes, which include the taxes on sales of oleomargarine, adulterated butter, filled cheese, mixed flour, white phosphorus matches and narcotics, and the child labor tax. Another measure which is out of place in a scheme of taxation is the National Prohibition Act.

The Internal Revenue Bureau should be rid of the regulatory taxes and of the enforcement of prohibition, because they do not produce appreciable revenue, because they are police measures rather than tax measures, because they constitute a very real menace to the morale of the revenue service, and because the Internal Revenue Bureau needs in more fertile fields the services of its officers and employees now acting as thinly disguised agents of the Department of Justice. To the extent that these taxes and measures serve any useful purpose, let them be transferred to a Bureau of Internal Regulation. The Internal Revenue Bureau cannot administer them and still function efficiently as a tax-gathering agency.

Next, first and foremost of the revenue taxes, for the reasons already given, the excess profits tax should be repealed. The child labor tax having gone with the other regulatory taxes, there would be left in our Class I, income taxes, only the income tax.

Thirdly, the estate tax, comprising our Class II, inheritance taxes, should probably be repealed. There is a strong sentiment that, the war emergency having ceased, inheritance taxes should be left to the States. In a federal budget of $4,000,000,000 the loss by the repeal of the estate tax of its yield of $100,000,000 would not be hard to make up elsewhere.

Fourthly, the trivial taxes, by which are meant taxes designed

to produce substantial revenue, but which fail in their object, should be repealed. These include all the present occupation taxes, our Class III, except the capital stock tax, and many of the sales taxes, our Class IV. The trivial taxes should be abolished because they are not worth the trouble to the Internal Revenue Bureau and the irritation to the taxpayers occasioned in collecting them. Together with the regulatory taxes their total yield is less than $35,000,000.

With the trivial taxes I should like to see the capital stock tax abolished. Its yield is not quite $100,000,000. Like the excess profits tax it is incapable of equitable administration, and it seems like an inexcusable last straw when superimposed upon the burden of other taxation which corporations have been and doubtless will be compelled to bear.

The foregoing proposals involve the elimination of practically all the hundred or more taxes (counting separate objects of taxation) now administered by the Internal Revenue Bureau, except the income tax and some of the sales taxes. The small loss of revenue from the abolition of the regulatory taxes and the trivial taxes would be more than offset by the release of a multitude of revenue officers for more important duties. The substantial loss of revenue from the abolition of the capital stock tax and the estate tax could conveniently be made up by an adjustment of the income tax, or preferably through taxation of sales. The very great loss of revenue from the abolition of the excess profits tax, figured on its past productivity, must be met through new taxes or an increase in old taxes.

Revision of Remaining Taxes.

Of the remaining taxes, the income tax and some of the sales taxes, the income tax should unquestionably stay, but it requires considerable revision.

For the reasons already advanced the higher rates of surtax

should be materially lowered. As they are now they kill the goose that lays the golden eggs. The Secretary of the Treasury has recommended the reduction of the maximum surtax to 20 per cent, or at least the limitation to 20 per cent of the surtax on income saved and reinvested in taxable securities. The latter proposal introduces infinite complications, of which we already have too many, and is an indirect method of bringing about practically the same result as the unconditional limitation to 20 per cent. I favor the direct method.

It would not be fair to repeal the excess profits tax without attempting in some way to equalize the respective positions of businesses conducted by individuals or partnerships, on the one hand, and by corporations, on the other hand. The most practical proposals so far made are either to tax the undistributed profits of corporations 20 per cent or to raise the present rate of income tax on corporations to 16 per cent. Neither of these suggestions is entirely satisfactory. This problem, however, diminishes in importance as the rates of surtax on individuals are lowered.

Other reforms in income taxation, such as the apportionment of the tax on sales of capital assets and the extension of the deduction for net losses, I have not time to take up in this necessarily general discussion.

The most needed reforms, such as reduction of the surtaxes, will without much doubt temporarily result in a diminished productivity of the income tax. The estate tax we have tentatively agreed to discard. New occupation taxes, if high enough to yield any substantial revenue, could obviously not be imposed at flat rates on both large and small enterprises. Referring to our original classification of internal taxes into income taxes, inheritance taxes, occupation taxes and sales taxes, it must be evident that unless some new kind of tax be discovered practically our sole remaining recourse is to existing or new sales taxes.

Taxation of Sales.

The necessity for the taxation of sales is admitted by practi-

cally everyone. The only difference of opinion is as to how and what sales should be taxed.

There are two widely different proposals or programs now before the country for its verdict. One of these I shall call the political program because it is chiefly fathered by politicians and others close to them who consider it the most practical program from a political standpoint. The other I shall call the business program because a tremendous body of business sentiment is back of it. The political program favors specific sales taxes; the business program favors a gross sales or turnover tax. Let us first make sure of our terms.

A specific sales tax is a tax on the sale of a specified article when made by or to a specified person. A gross sales or turnover tax, as the term has come to be understood, is a tax on the sale of every article when made by or to any person.

The difference may be illustrated by considering the application of some of the existing specific sales taxes, say those on candy, jewelry and soda water, to the case of a department store, which, as would not be unusual, makes some of its candy and jewelry and also sells at wholesale to small dealers. Such a department store must pay a tax on the candy it makes, but not on the candy it buys and resells, for the tax on candy is only on sales by the manufacturer. On the other hand, the store need pay no tax on the jewelry it makes and sells to other dealers, but must pay a tax on the jewelry it sells at retail, for the tax on jewelry is only on sales to the ultimate consumer. Still again, its duty in the case of soda water is not to pay the tax, but only to collect it from the purchaser, who is primarily liable for it. Of course, these are only examples of many articles a department store ordinarily sells, some of which are taxable at varying rates and others not at all.

A turnover tax, on the contrary, would apply at the same rate to every sale of every article dealt in by the department store.

To particularize, the political program contemplates the retention of most of the existing seventy-five or so specific sales taxes, the increase in the rates of the taxes on automobiles, candy, toilet soap, musical instruments, jewelry, admissions, motion picture films, tobacco and certain other things, and the imposition of new taxes on gasoline and perhaps tea, coffee and sugar.

The existing specific sales taxes yield annually about $1,000,000,000, and it is estimated that about $500,000,000 additional could be collected as a result of the changes proposed. But the repeal of the excess profits tax and the reduction of the higher rates of surtax would still leave a deficiency of about $500,000,000. To meet this the advocates of a specific sales tax program suggest in part making the rate of income tax on incomes up to $4,000 or $5,000, 6 per cent instead of 4 per cent; and on incomes up to $10,000, 12 per cent instead of 8 per cent; and increasing the lower rates of surtax.

The business program, on the other hand, contemplates the abolition of all the existing specific sales taxes and the enactment of a uniform tax at the rate of one per cent or less on all sales of over $500 a month or $6,000 a year. Sales of smaller amount would not be worth taxing. Such a tax would yield at least $2,000,000,000. Instead of raising the lower rates of income tax, as proposed by the political program, the existing exemptions of $1,000 for single and $2,000 for married persons could be raised to $3,000 and $4,000 respectively.

Comparison of Sales Tax Programs.

Suppose we compare the chief advantages and disadvantages of these two programs, from the standpoint, first, of their administration by the Internal Revenue Bureau; second, of their effect on the country; and, third, of their capacity to produce revenue.

First, as to ease of administration, there is practically no comparison. Under the business program the merchant merely takes

one per cent of his total sales for the month and sends a check for this amount to the tax collector. Checking such a computation is child's play for the revenue agent when he comes to examine the merchant's books. On the other hand, under the political program, consider what complicated computations our department store, for example, has to work out! When the revenue agent comes around he has to decide what articles are taxable, whether in each case the sale by the merchant was taxable or not, and what rate of tax applies.

Very serious administrative difficulties in the collection of specific sales taxes imposed on sales by the manufacturer, producer or importer arise from the necessity of determining in each instance who is the manufacturer, producer or importer, and what articles are taxed. Very serious difficulties of administration arise in connection with all specific sales taxes imposed on sales to the consumer or user, not only from the necessity of identifying the article, but also from the necessity of determining in each instance who is the consumer or user. At present there are at least 20 separate sets of regulations, each a sizable pamphlet, promulgated by the Internal Revenue Bureau to instruct its employees and the public regarding the idiosyncrasies of each specific sales tax. With the substitution of a turnover tax for the specific sales taxes all these difficulties of administration would very largely disappear.

Second, as to their effect on the country, the wildest speculations are advanced by people who do not take the trouble to think. While I cannot in my allotted time attempt to mention, much less answer, all the arguments on one side or the other, I can perhaps lay a basis for intelligent consideration of the questions involved.

To begin with, both programs involve what are in effect consumption taxes. That means that the ultimate consumer will pay the tax, as he always has done. There is no use dodging this fact. The political program proposes raising at least $1,500,000,000 from specific sales taxes, and, of course, with rates of tax

around ten per cent the seller must pass along the tax to the purchaser or go out of business.

But the difference between the two programs is that the political program tries to concentrate the burden on the consumers of a comparatively few articles, while the business program spreads the burden over all consumers. One valid objection to the present tax system is that it offers too good an excuse to increase commodity prices. The Department of Justice estimates that prices in general have been loaded for tax reasons something like 23 per cent. In the event of further recourse to high specific sales taxes it is probable that similar over-loading would continue. With a uniform one per cent tax on all articles, the merchant who raised his prices ten or twenty per cent "because of taxes" would receive little sympathy.

Perhaps we can best compare the effect of the two programs by observing their application to typical persons. Let us take a single man who earns $3,000 a year. Under existing law he pays $80 a year in income tax and heaven knows what in other taxes shifted upon him. Under the political program he would pay $120 a year in income tax, and his payment of further taxes would depend to some extent on his success in avoiding the purchase of taxable articles. If he bought a Ford, or a Victrola, or a Kodak, or toilet soap, or candy, or tobacco, or a fur article, or soft drinks, or gasoline, or a number of other articles, he would pay a tax at high rates. Under the business program, on the contrary, he would pay no income tax. If he spent all of his $3,000 he might (as later shown) pay $60 in turnover taxes.

You can figure out for yourselves the effect of the programs on persons with incomes of other amounts. I think you will find that in the case of the smaller incomes the burden of tax will be less under the business program than under either the political program or the present system. This is not hard to explain. One reason, as we have seen, is that profiteers have taken as profits increases in prices which they attributed to high taxes.

But another reason is that, while under the business program the more people spend the more tax they have to pay, under the political program this is by no means necessarily so. For example, a man who has and spends an income of $3,000 and a man who has and spends an income of $100,000 may both buy Victrolas, a taxable article, and pay pretty nearly the same amount of tax. The rich man does not buy 30 Victrolas because his income is 30 times that of the poorer man. On the contrary, he is likely to spend the rest of his income for non-taxable articles, such, for instance, as a racing stable.

Probably the greatest single advantage of the business program is the low rate which a turnover tax makes possible. Of course, being imposed on every sale, there is a cumulative effect when the same articles or their component parts are sold several times. But in the case of articles subject to the most turnovers the total tax will not exceed 3¼% per cent of the final selling price. This has been worked out mathematically for a number of articles. The tax in most cases will probably average not more than 2 per cent. Compare this with the 10 per cent rates of most of the specific sales taxes.

This turnover feature is the target for the bitterest attacks on the business program. It is said that the turnover tax will put the middleman out of business. This argument is purely superficial. If at the present time the services of a middleman are worth his expenses and profits, an additional 1 per cent will not ruin him. If the services of a middleman are of such doubtful economic value that the difference of 1 per cent is going to make or mar him, his loss will be a benefit to business in general. Similar considerations apply to the relative positions of so-called multiple process enterprises and single process enterprises. They exist side by side today, each with its special advantages, and a 1 per cent tax can scarcely cause a revolution.

As no tax is perfect and all taxes of necessity result in inequalities, that tax is the fairest whose rate is the lowest, for inequalities

are minimized. One trouble with the excess profits tax is that Congress attempted to remedy the glaring inequalities arising from the high rates, with the result that each intended remedial provision occasioned ten inequalities for every one that existed before.

Third, as to their capacity to produce revenue, there is again no real comparison between the two programs. The political program may yield $1,500,000,000 from specific sales taxes and must resort to increases in the income tax for further revenue. The business program will yield at least $2,000,000,000 from the turnover tax. One of the objections to the turnover tax is that it may produce too much revenue. If so, the rate can be lowered.

To sum up, the present system of federal taxation should be changed because, among other reasons, the Internal Revenue Bureau cannot administer the existing taxes, the country cannot prosper under them, and the Government cannot derive enough revenue from them. It is agreed that the excess profits tax should go and the higher rates of surtax be lowered. The repeal of miscellaneous taxes and the further revision of the income tax also seem highly advisable. To supplement the income tax we can have a heterogeneous collection of specific sales taxes or a uniform turnover tax. For my part I favor, as the nearest approach to an ideal system of federal taxation, the income tax plus the turnover tax, these two and no others, balancing and equalizing each other, together providing adequate revenue with the least burden of collection and of payment.

It is for the country to choose. Details are unimportant until an agreement be reached on the basic principles to govern the revision of federal taxation.

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